

SECURITIES ALERT

SEC ANNOUNCES POSTPONED INTERNAL CONTROL COMPLIANCE DATE FOR NON-ACCELERATED FILERS AND MAKES PLANS TO IMPROVE IMPLEMENTATION OF SECTION 404 REQUIREMENTS



On May 17, 2006, the Securities and Exchange Commission (SEC) announced that it would grant a brief postponement of the date by which non-accelerated filers¹ must comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act.² The SEC also announced that it would give more effective guidance to management on meeting the reporting requirements as well as improve the implementation of Section 404 by taking the following actions:

- Gathering input from management in order to give guidance tailored to management needs and concerns
- Assisting and giving final approval to the Public Company Accounting Oversight Board (PCAOB) in its revision of Auditing Standard No. 2
- Overseeing the PCAOB inspection process to ensure that oversight of auditing firms is encouraging efficient and cost effective implementation of Section 404

POSTPONED INTERNAL CONTROL COMPLIANCE DATE FOR NON-ACCELERATED FILERS

The SEC announced a “short postponement” of the effective date of the rules implementing Section 404 for non-accelerated filers. Although the SEC did not specify the effective date, the SEC anticipates that such postponement would ultimately require all filers to comply with

¹ Non-accelerated filers are generally U.S. and foreign companies with less than \$75 million in worldwide public float.

² Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, companies who must provide annual financial reports must include an “internal control report” detailing management’s responsibility for establishing and maintaining an adequate internal control structure for overseeing financial reporting. The report must also contain an assessment at the end of the most recent fiscal year of the effectiveness of the internal control structure in monitoring procedures for financial reporting. Subsection (b) requires that a registered public accounting firm that prepares or issues the audit report attest to the assessment made by management of the effectiveness of the internal control structure.

Section 404(a) requirements for fiscal years *beginning* on or after December 16, 2006. Previously, non-accelerated filers were required to comply by their first fiscal year *ending* on or after July 15, 2007. The postponement is intended to allow non-accelerated filers to benefit from the SEC's forthcoming guidance and implement the PCAOB revisions of Auditing Standard No. 2. The slight postponement will have no effect on non-accelerated filers whose fiscal years coincide with the calendar year.

ANNOUNCED PLANS TO ISSUE GUIDANCE

The SEC announced that all companies, including the smallest company filers, would ultimately have to comply with the internal reporting requirements of Section 404. Therefore, in response to requests for additional guidance on how to complete an assessment of internal controls, the SEC plans to take the following steps:

- ***Concept Release and Opportunity for Public Comment.*** The SEC will issue a Concept Release that will cover various topics the SEC might address in guidance to management. With the Concept Release, the SEC will seek comment as to whether the proposed issues meet the needs and concerns of management of public companies of all sizes. The SEC will also seek comment on the appropriate role of outside auditors in management's assessment of an organization's internal controls under Section 404(a) and on methods auditors use to provide the attestation required by Section 404(b). The SEC plans to use the comments in its consideration of alternative approaches to outside auditors' roles in both areas.
- ***Consideration of Additional Guidance from COSO.*** The SEC stated that it supports forthcoming guidance from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) on its 1992 Internal Control — Integrated Framework. As it develops its guidance, the SEC will consider how COSO guidance is useful to smaller companies as well as companies of all sizes in applying the framework to internal controls in financial reporting.
- ***Guidance on "Top-Down, Risk-Based" Assessment.*** Though the form of guidance is still undetermined, the SEC plans such guidance to respond to comments that the internal control reporting under Section 404 has not reflected the "top-down, risk-based" approach the SEC intended.³ Using the information gathered from the Concept Release and COSO, the SEC will issue guidance to assist management in utilizing this approach in its reporting. However, the SEC adds that the guidance will be "scalable and responsive" to the individual circumstances of smaller public companies and sensitive to the fact that many companies have already invested considerable resources to comply with Section 404.

ANNOUNCED PLANS TO ASSIST AND OVERSEE THE PCAOB IN THE REVISION AND IMPLEMENTATION OF AUDITING STANDARD NO. 2

The PCAOB announced that it would propose revisions to Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. The revisions the PCAOB will propose are intended to insure that auditors focus on areas that pose a "higher risk of fraud or material error" and incorporate the concepts of the PCAOB's May 16, 2005, guidance, encouraging auditors to take a "top-down, risk-based" approach to auditing internal control reports and assessments. The PCAOB will also clarify the outside

³ This approach requires that management apply in a reasonable manner its cumulative knowledge, experience and judgment to identify the areas of the financial statements that present significant risk that the financial statements could be materially misstated and then proceed to identify relevant controls and design appropriate procedures for documentation and testing of those controls.

auditor's role, if any, in evaluating the company's process of assessing internal control effectiveness. The SEC will not only approve the PCAOB's final version of the standard, but will also work closely with the Board to ensure that revisions are consistent with the goal of protecting investors.

The PCAOB also announced it would focus its 2006 Inspection Program on whether auditors have achieved "cost-saving efficiencies" in the audits performed under Auditing Standard No. 2, following guidance the PCAOB issued encouraging them to do so. In its oversight capacity, the SEC will examine whether the PCAOB inspection of auditing firms has effectively encouraged efficiency and cost-effectiveness in Section 404 implementation.

SEC Chairman, Christopher Cox, explained that as the SEC proceeded, it would "consider the special concerns of all companies that fall under [SEC] jurisdiction — large and small, foreign and domestic" and would "take a giant step toward 'getting it right' when it comes to Section 404 compliance."

CONTACT INFORMATION

If you have questions or would like to learn more about this topic, please contact the partner who represents you, or:

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